No. 92-1382

In The

Supreme Court of the United States

October Term, 1992

MEDALLION OIL COMPANY, *et al.*,

Petitioners,

v.

TRANSAMERICAN NATURAL GAS CORPORATION, *et al.*,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

MOTION FOR LEAVE TO FILE *AMICUS CURIAE* BRIEF AND *AMICUS CURIAE* BRIEF FOR INDEPENDENT BANKERS ASSOCIATION OF TEXAS IN SUPPORT OF PETITIONER

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Independent Bankers Association of Texas ("Independent Bankers"), the applicant, respectfully moves this Court for leave to file the brief attached hereto in this case as *amicus curiae*. The consent of the attorney for the petitioner herein has been obtained. The attorney for the respondent herein has refused to consent to the filing of a brief by the applicant as *amicus curiae*.

The applicant's member banks have a special interest in Texas law concerning the rights of overriding royalty holders in producing oil and gas properties because such overrides can and do form the basis of collateral for energy loans throughout the State of Texas.

The petitioner in this petition for writ of certiorari focuses, appropriately, on the effects of the Fifth Circuit decision on the holders of overriding royalty interests. Applicant seeks leave to file its brief as *amicus curiae* in order to apprise the Court of the broad consequences of the Fifth Circuit decision for the Texas banking industry. The interests of applicant's members will not be adequately represented by petitioner in this case.

Respectfully submitted,

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March 1993

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STATEMENT OF INTEREST

Independent Bankers Association of Texas ("Independent Bankers") is a trade association representing some 800 independent, community banks in Texas. The decision by the Fifth Circuit jeopardizes the value of overriding royalty interests currently held as collateral for energy loans by independent banks throughout the State of Texas. Energy loans constitute a significant portion of existing loans held by member banks and overriding royalty interests form collateral for important

numbers of these loans. The Fifth Circuit opinion threatens not only the sufficiency of existing collateral for outstanding loans, but also threatens the base for future energy lending in Texas.

ARGUMENT

Royalty interests have long formed the basis of valuable collateral for loans made by Texas banks. Interests in oil and gas properties are recognized as important assets and certainty as to the legal enforceability of those interests is essential to the commerce of Texas that revolves around such interests. Certainty is the key to the value of those interests.

Prior to the Fifth Circuit's decision in this case, there was certainty under Texas law as to the enforceability of overriding royalty interests. That certainty was based on Texas oil and gas property law as well as oil and gas industry custom and practice.

The issues in the instant case are essentially questions of contract construction. It is a fundamental proposition of contract construction under Texas law that the language of contract is to be considered in light of industry custom and practice. *Sun Oil Company v. Madeley*, 626 S.W.2d 726 (Tex. 1981). Therefore, to reach a correct resolution of the issues in this case, a court must not only understand the intricacies of Texas oil and gas law, but also must be prepared to analyze those issues in light of the custom and practice of the oil and gas industry in Texas. The Texas Supreme Court is the tribunal most appropriately, if not uniquely, equipped to accomplish

those tasks. For that reason, certification of the previously undecided question of Texas law to the Texas Supreme Court would be particularly warranted in this case.

To appreciate the economic consequences of the Fifth Circuit decision, one must understand oil industry practice regarding the development of oil and gas producing properties and the role of overriding royalties in that development. The contractual relationships among the parties in this case were ordinary and customary in the oil and gas industry in Texas. Quite often, as in this case, there are three parties involved. The landowner, or lessor, owns fee simple title to the mineral interests under a particular parcel of land. The oil and gas production company, the lessee, seeks to lease from landowners the mineral rights under promising properties and to develop and produce the oil and gas from those properties. Search companies, or finders, are employed by production companies to acquire leases for the production companies from the owners of prospective properties. In the instant case Medallion Oil Company was the search company finder, Transamerican Natural Gas Corporation ("Transamerican") was the production company lessee, and El Paso Natural Gas Company was the landowner lessor.

Contractual arrangements among the parties typically, as in this case, provide that the lessee will bear the cost of exploration, development, drilling and production on the property. In return, the lessee will be entitled to a contractually fixed percentage of the oil and gas produced. The landowner lessor in turn will be entitled to a contractually fixed percentage of the oil and gas produced by the lessee from the property in the form of a royalty interest.

Similarly, the contract between the search company and production company lessee typically, as in this case, provides that the search company finder will be compensated for acquiring the lease by receiving a fixed percentage of the production from the property. Often, this interest is an overriding royalty. Consequently, the landowner lessor, the production company lessee and the search company finder all depend on the success of the production company's drilling and production efforts for the income to be received by virtue of their respective mineral interests. The so-called "surrender clause" contained in the lease in the instant case likewise is a customary provision in the industry.

Once a property begins to produce marketable quantities of oil and gas, the landowner lessee, the production company lessee and the search company finder all have valuable property interests that can be pledged as collateral for loans from Texas banks. In considering the value of those property interests as collateral, one of the bank's considerations is the price of oil and gas in the market and the stability of that market. The most important consideration, however, is the production itself – what is the level of production, how long will it continue and at what levels.

In making a loan secured by the finder's overriding royalty, the bank assumes the risk that the production might decline or cease altogether. The bank evaluates that risk on the basis of reserve reports prepared by petroleum engineers and other experts analyzing the potential production capability of the producing well.

The Fifth Circuit decision has undermined the value of overriding royalties as loan collateral. Regardless of the strength of production levels from a given property, and the scientific indicators of continued production, there now exists the new, unforeseen risk that the lessee might purchase from the lessor the fee title to the minerals and thereby terminate the overriding royalty.

The Fifth Circuit did not save overriding royalty interests as collateral by the qualifying statement in the court's opinion on rehearing that the result might have been different had there been a showing of bad faith. The uncertainty inherent in a determination of bad faith renders this qualification meaningless for purposes of evaluating an override as collateral. The economics of the situation demand a bright line test.

The reasonable expectations of Texas bankers in lending on the basis of overriding royalties as collateral arose out of industry custom and practice recognized by Texas oil and gas law as stated in *Cain v. Neumann*, 316 S.W.2d 915 (Tex.Civ.App. – San Antonio 1958, no writ). In that case a lessee attempted to terminate an overriding royalty interest in a producing property by cancelling the underlying lease and, simultaneously, entering into a new lease agreement with the landowner lessor, while production from the property continued unabated. In *Cain*, as in the present case, the original lease provided that its term would continue so long as production continued. In *Cain*, as in the present case, the lessee contended that it had surrendered the lease and, thereby, terminated the overriding royalty. *Cain* held that a lessee who continues to hold the property and continues to produce minerals from it cannot cut off the overriding royalty interest by a

purported termination of the underlying lease. So long as production continues, so does the overriding royalty.

In *Cain* the lessee attempted to terminate the overriding royalty by cancelling one lease and taking another. In the instant case, the lessee Transamerican has attempted to terminate the overriding royalty by cancelling the lease and acquiring the fee title to the property. Certification of this important question of Texas oil and gas law to the Texas Supreme Court is particularly warranted because of the widespread consequences for both the oil and gas and banking industries of Texas.

Absent certification by the Fifth Circuit, the likelihood of the question finding its way to the Texas Supreme Court through other cases is remote. The instant case points up the fact that Texas jurisprudence regarding the status of mineral interests and other collateral increasingly has become the domain of the federal bankruptcy courts. The common denominator in most disputes regarding the enforceability of security interests in real property today is bankruptcy. Consequently, unless the issue is certified to the Texas Supreme Court, the Fifth Circuit determination of this important question of Texas law will be the controlling precedent for the foreseeable future.

SUMMARY OF ARGUMENT

The decision of the Fifth Circuit in this case undercuts the value of overriding royalty interests as collateral for existing and future loans. The value of those interests depends upon the certainty of their enforceability. That

certainty can come only from resolution by the Texas Supreme Court of the important, previously undecided question of Texas oil and gas law presented by this case.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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